DEPARTMENT OF STATE REVENUE

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Letter of Findings Number: 04-0468
Income Tax
For Tax Years 2000-02

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ISSUES

I. Income Tax–Corporate.

Authority: IC § 6-3-2-2; IC § 6-8.1-5-1; 45 IAC 1.1-1-2; 45 IAC 3.1-1-44.

Taxpayer protests the assessment of corporate income tax.

II. Tax Administration–Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the imposition of a ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer operates a business in Indiana. As the result of an audit, the Indiana Department of Revenue ("Department") issued proposed assessments for income tax, negligence penalty, and interest for the tax years 2000, 2001, and 2002 based on the best information available. Taxpayer protested the imposition of tax and penalty. The Department conducted a further investigation with more documentation supplied by Taxpayer. The Department reduced the original proposed assessments by approximately half. Taxpayer continues to protest two adjustments in the remaining amount of tax, along with one item not adjusted, and imposition of penalty. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Income Tax–Corporate.

DISCUSSION

Taxpayer protests the imposition of income tax for the years 2000, 2001, and 2002. Taxpayer points to three items in the Department's adjustments. First, Taxpayer states that much of what the Department considered income was actually reimbursements from the federal government for purchases made pursuant to an agency relationship. Second, Taxpayer states that the Department incorrectly increased the property factor numerator in the apportionment formula. Third, Taxpayer states that the Department did not include some inventory in the property factor of the apportionment formula. The Department notes that the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made, as provided by IC § 6-8.1-5-1(c).

Taxpayer's first point of protest is the Department's determination that certain payments were gross income to Taxpayer, rather than reimbursements in an agency relationship. The Department based its determination on the lack of documentation establishing the nature of the relationship between Taxpayer and the other party. Taxpayer protests that the other party is the federal government and that, due to the federal government's security restrictions, Taxpayer is not allowed to reveal complete contracts and agreements to other parties, including the Department. Taxpayer provided what documentation it was allowed to reveal in support of its position that the funds received from the federal government were received in an agency capacity.

The gross income tax was repealed in 2003. However, the relevant regulation was 45 IAC 1.1-1-2, which stated:

(a) "Agent" means a person or entity authorized by another to transact business on its behalf.

(b) *A taxpayer will qualify as an agent if it meets both of the following requirements*:

(1) The taxpayer must be under the control of another. An agency relationship is not established unless the taxpayer is under the control of another in transacting business on its behalf. The relationship must be intended by both parties and may be established by contract or implied from the conduct of the parties. The representation of one (1) party that it is the agent of another party without the manifestation of consent and control by the alleged principal is insufficient to establish an agency relationship.

(2) *The taxpayer must not have any right, title, or interest in the money or property received from the transaction.* The income must pass through, actually or substantially, to the principal or a third party, with the taxpayer being merely a conduit through which the funds pass between a third party and the principal.

(*Emphasis added.*)

In this case, while Taxpayer has provided documentation establishing that its client had approval of certain equipment purchases by Taxpayer, there is no documentation establishing that Taxpayer had no right, title, or interest in the money or property received from the transactions. As explained by 45 IAC 1.1-1-2(b)(2), Taxpayer must not have had any right, title, or interest in the money or property received from the transactions in order to qualify as an agent for Indiana gross income tax purposes. Taxpayer protests that it is not allowed to reveal most of the details of its contracts and agreements with its client, due to federal restrictions. The Department

understands these restrictions, but refers back to IC § 6-8.1-5-1(c) which establishes that the burden of proving a proposed assessment wrong rests with Taxpayer. Taxpayer has not met this burden regarding funds received from the federal government.

Taxpayer's second point of protest is the adjustment to increase the property factor numerator for adjusted gross income tax for the tax year 2000. The property factor of the apportionment formula is explained at IC § 6-3-2-2(c), which states:

> The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the taxable year and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the taxable year. However, with respect to a foreign corporation, the denominator does not include the average value of real or tangible personal property owned or rented and used in a place that is outside the United States. Property owned by the taxpayer is valued at its original cost. Property rented by the taxpayer is valued at eight (8) times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from subrentals. The average of property shall be determined by averaging the values at the beginning and ending of the taxable year, but the department may require the averaging of monthly values during the taxable year if reasonably required to reflect properly the average value of the taxpayer's property.

The Department added $4,900,000 to the property factor numerator to reflect that amount of property in Indiana. A review of the audit report shows that, due to lack of documentation, the Department had to approximate the value of the Indiana property. Taxpayer originally protested that the adjustment was wholly in error. After the administrative hearing, Taxpayer sent documentation and explanation showing that the adjustment was only incorrect in the amount which should have been added to the property factor numerator. Taxpayer determined that the actual amount to be added was $4,036,625. Taxpayer has met the burden imposed by IC § 6-8.1-5-1(c).

Taxpayer's third point of protest is the Department's decision not to make an adjustment to the property factor to include work in process ("WIP") in the form of uncompleted contracts and related costs of advance billings. The Department adjusted the inventory in the audit report to agree with the inventory on the balance sheet of Taxpayer's federal income tax returns. The Department did not include the WIP which Taxpayer believes should be included. The relevant regulation is 45 IAC 3.1-1-44, which explains:

> Property owned by the taxpayer is valued at original cost. If the original cost cannot be ascertained, the property is valued at fair market value as of the date of acquisition by the taxpayer.
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> "Original cost" does not make allowance for depreciation.
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> Examples:
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> (1) The taxpayer, using the calendar year basis of reporting income, acquires a plant in Indiana for $500,000 at the first of the year. In July, it expends $100,000 in remodeling the facility. It claims depreciation for the year of $22,000. The value of the plant for purposes of the property factor is $600,000.
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> (2) X Corporation merges into Y Corporation during the tax year in a reorganization which is tax-free under the Internal Revenue Code. At the time of the merger, X owned a factory which it originally built ten years earlier at a cost of $1,000,000 and which had a basis of $900,000 due to depreciation. Since the factory is acquired by Y in a transaction in which under the Internal Revenue Code its basis is the same for Y as it was for X, Y will include the property in the property factor at X's original cost: $1,000,000.
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> (3) Corporation Y acquires the assets of Corporation X in a liquidation by which Y is entitled under Internal Revenue Code § 334(b)(2) to use the original cost of X stock as the basis for X's assets (i.e., stock possessing 80% control of X is purchased and liquidated within 2 years). Y's cost of X's assets is the purchase price of X stock prorated over the assets.
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> *Inventory is included in the property factor in accordance with the valuation method used by the taxpayer for Federal income tax purposes.* Property acquired by gift or inheritance is valued at its basis for determining depreciation for Federal income tax purposes.
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> The taxpayer's owned property is generally valued at its average value at the beginning and ending of the tax year.
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> (*Emphasis added.*)

Taxpayer states that the WIP is included in other areas of the federal return. Taxpayer provided several balance sheets explaining the amounts of the WIP and how Taxpayer arrived at those numbers. Taxpayer did not explain where in the federal return the WIP was included. While the Department understands how Taxpayer arrived at those figures, the documentation is insufficient to establish that the WIP is included in the federal return, as required by 45 IAC 3.1-1-44. Therefore, Taxpayer has not met the burden imposed by IC § 6-8.1-5-1(c).

In conclusion, Taxpayer has not met the burden of proving that it received funds in an agency capacity. Taxpayer has met the burden of proving that the amount which should be added to the property factor numerator is $4,036,625. Taxpayer has not met the burden of proving that WIP should be included in the property factor.

FINDING

Taxpayer's protest is sustained in part and denied in part.

II. Tax Administration–Negligence Penalty.

DISCUSSION

The Department issued proposed assessments and the ten percent negligence penalty for the tax year in question. Taxpayer protests the imposition of penalty. The Department refers to IC § 6-8.1-10-2.1(a), which states in relevant part:

If a person:

. . .

(3) incurs, upon examination by the department, a deficiency that is due to negligence;

. . .

the person is subject to a penalty.

The Department refers to 45 IAC 15-11-2(b), which states:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

45 IAC 15-11-2(c) provides in pertinent part:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

In this case, taxpayer incurred a deficiency which the Department determined was due to negligence under 45 IAC 15-11-2(b), and so was subject to a penalty under IC § 6-8.1-10-2.1(a). Taxpayer was partially sustained in Issue I, and has provided reasonable explanations for the portions upon which it was denied. Taxpayer has affirmatively established that its failure to pay the deficiency was due to reasonable cause and not due to negligence, as required by 45 IAC 15-11-2(c).

FINDING

Taxpayer's protest is sustained.

CONCLUSION

Taxpayer is sustained regarding the addition of $4,036,625 to the property factor numerator, rather than the $4,900,000 originally added. Taxpayer is denied on the amounts claimed as agency receipts and on the amounts of WIP requested to be added to the property factor. Taxpayer is sustained on the negligence penalty.

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